

**Letter of Findings: 02-20200382  
Composite Tax Return  
For the Year 2019**

**NOTICE:** IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

### HOLDING

The Department erred in assessing Partnership additional tax on distributions to its nonresident-partners because Partnership was owned by two non-captive Real Estate Investment Trusts ("REITs") and because Partnership established that Indiana corporate income tax was not owed on the two REITs' distributive share of Indiana income.

### ISSUES

#### **I. Composite Tax - Real Estate Investment Trust Dividends.**

**Authority:** IC § 6-3-1-3.5(b); IC § 6-3-1-11; IC § 6-3-1-34.5; IC § 6-3-2-1(b); IC § 6-3-2-2; IC § 6-3-4-12(a); IC § 6-8.1-5-1(c); *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); I.R.C. § 857; [45 IAC 3.1-1-107](#)(a)(2); Black's Law Dictionary (11th ed. 2019).

Taxpayer argues that the Department erred in assessing additional income tax on the ground that Taxpayer is owned by two Real Estate Investment Trusts ("REITs") and that Indiana corporate income tax is not owed on the two REITs' distributive share of Indiana income.

#### **II. Composite Tax - Underpayment Penalty.**

**Authority:** IC § 6-3-4-4.1; IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); [45 IAC 15-11-2](#).

Taxpayer maintains that it is entitled to abatement of the 10 percent "underpayment penalty."

### STATEMENT OF FACTS

Taxpayer is an out-of-state investment partnership which earns money from Indiana sources. According to Taxpayer, it is 97 percent owned by two partners which are, in turn, owned by two REITs. Taxpayer's income passes through to its partners which subsequently distribute the income to the REITs.

Taxpayer filed an Indiana 2019 Indiana Partnership Return (Form IT-65 Indiana Partnership Return). Taxpayer initially reported its net income prior to payment of dividends but claimed a deduction for income apportioned to the two REITs. The Department subsequently reviewed the return and reversed the deduction which resulted in an assessment of additional tax on income distributed to its nonresident shareholders.

Taxpayer disagreed with the assessment of additional tax and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

#### **I. Composite Tax - Real Estate Investment Trust Dividends.**

### DISCUSSION

The issue whether Taxpayer has met its burden of establishing that it was not required to withhold tax on income received in Indiana but ultimately distributed as dividends to two REITs.

Under Indiana law, Taxpayer has the burden of establishing that the proposed assessment was wrong. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486, fn. 9 (Ind. Tax Ct. 2012).

Indiana imposes a tax on the adjusted gross income of every corporation that has adjusted gross income derived from sources within Indiana. IC § 6-3-2-1(b); IC § 6-3-2-2. To compute the income subject to Indiana corporate income tax, Indiana adopts a multistep process to calculate a corporation's taxable Indiana adjusted gross income. *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 581 (Ind. 2014). Indiana generally follows the tax principles established in the federal law. IC § 6-3-1-11. Indiana statutes refer to the Internal Revenue Code to compute what is considered the taxpayer's Indiana income tax. IC § 6-3-1-3.5(b) provides the starting point to determine a corporation's taxable income, stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows . . . ." In determining the taxpayer's Indiana adjusted gross income, Indiana first refers to I.R.C. § 63 as the beginning point. In other words, when used "[i]n the case of corporations," the term "'adjusted gross income' shall mean the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code)" with certain modifications. IC § 6-3-1-3.5(b).

Taxpayer explains that it is owned in large part (97 percent) by two nonresident partners. In turn, one partner is 98 percent owned by a REIT designated here as "Investor." The other partner is 97 percent owned by a second REIT designated as "Realty." (A REIT is "[a] company that invests in and manages a portfolio of real estate, with the majority of the trust's income distributed to its shareholders." Black's Law Dictionary 1516 (11th ed. 2019)).

Indiana requires partnerships to withhold and remit withholding payments on distributive shares of partnership income allocated to nonresident partners. IC § 6-3-4-12(a) provides:

Every partnership shall, at the time that the partnership pays or credits amounts to any of its nonresident partners on account of their distributive shares of partnership income, for a taxable year of the partnership, deduct and retain therefrom the amount prescribed in the withholding instructions referred to in section 8 of this chapter. Such partnership so paying or crediting any nonresident partner:

- (1) shall be liable to the state of Indiana for the payment of the tax required to be deducted and retained under this section and shall not be liable to such partner for the amount deducted from such payment or credit and paid over in compliance or intended compliance with this section; and
- (2) shall make return of and payment to the department monthly whenever the amount of tax due under [IC 6-3](#) and [IC 6-3.6](#) exceeds an aggregate amount of fifty dollars (\$50) per month with such payment due on the thirtieth day of the following month, unless an earlier date is specified by section 8.1 of this chapter.

IC § 6-3-4-12(i) provides that partnerships *must* file a composite return on behalf of *all* nonresident partners. The statute requires:

A partnership shall file a composite adjusted gross income tax return on behalf of all nonresident partners. The composite return must include each nonresident partner regardless of whether or not the nonresident partner has other Indiana source income.

Taxpayer however points to [45 IAC 3.1-1-107](#)(a)(2) as justifying the manner in which Taxpayer originally reported its Indiana income. The regulation provides:

For a partner other than an individual partner, the income tax withheld may be calculated *using any reasonable method designed to reflect the ultimate tax liability due Indiana because of the partnership's activities*. As used in this section, "nonresident corporate partner" does not include a foreign corporation qualified to do business in Indiana. (*Emphasis added*).

Taxpayer explains that its original return reflected a "reasonable method" of reporting its Indiana income.

Taxpayer explains:

The REITs' federal and Indiana taxable income calculations include a deduction for dividends paid, which must be paid annually for the REIT entities [Investor and Realty] to maintain their REIT status. Consequently, federal and Indiana tax is not ultimately due on the REITs' distributive share of Indiana income from lower-tiered partnership entities such as Taxpayer. It is a hardship for Taxpayer to make a large Indiana nonresident withholding payment then for its ultimate owners [the two REITs] to seek of a refund of the same withholding tax remitted because of the REIT-specific dividends paid deduction.

Taxpayer points out that less than 3 percent of the Taxpayer's Indiana distributive share will be recognized by non-REIT owners and that both Investor and Realty receive a deduction for the dividends that the Investor and Realty pay its shareholders pursuant to I.R.C. § 857. Moreover, Indiana has not decoupled from the federal dividends paid deduction except in the case of "captive" REITs.

IC § 6-3-1-34.5 provides that a "captive" REIT is one which is not regularly traded on an established securities market *and* in which more than 50 percent of the voting power/beneficial interests or share are owned or controlled directly or constructively by a single entity which is subject to Subchapter C of the Internal Revenue Code. Specifically, the statute provides:

(a) Except as provided in subsection (b), "captive real estate investment trust" means a corporation, a trust, or an association:

- (1) that is considered a real estate investment trust for the taxable year under Section 856 of the Internal Revenue Code;
- (2) that is not regularly traded on an established securities market; and
- (3) in which more than fifty percent (50[percent]) of the:
  - (A) voting power;
  - (B) beneficial interests; or
  - (C) shares;

are owned or controlled, directly or constructively, by a single entity that is subject to Subchapter C of Chapter 1 of the Internal Revenue Code.

(b) The term does not include a corporation, a trust, or an association in which more than fifty percent (50[percent]) of the entity's voting power, beneficial interests, or shares are owned by a single entity described in subsection (a)(3) that is owned or controlled, directly or constructively, by:

- (1) a corporation, a trust, or an association that is considered a real estate investment trust under Section 856 of the Internal Revenue Code;
- (2) a person exempt from taxation under Section 501 of the Internal Revenue Code;
- (3) a listed property trust or other foreign real estate investment trust that is organized in a country that has a tax treaty with the United States Treasury Department governing the tax treatment of these trusts; or
- (4) a real estate investment trust that:
  - (A) is intended to become regularly traded on an established securities market; and
  - (B) satisfies the requirements of Section 856(a)(5) and Section 856(a)(6) of the Internal Revenue Code under Section 856(h) of the Internal Revenue Code.

(c) For purposes of this section, the constructive ownership rules of Section 318 of the Internal Revenue Code, as modified by Section 856(d)(5) of the Internal Revenue Code, apply to the determination of the ownership of stock, assets, or net profits of any person.

Taxpayer agrees that "Investor" is not publicly traded but explains that Investor is not a "captive" REIT because 50 percent of its voting power/beneficial interest/shares are not owned by a single corporate entity. Taxpayer explains:

[Investor] is owned by a diverse investor base in which no single investor directly nor constructively owns more than 10[percent] of the profit/loss/net equity of the partnership, nor its underlying REIT asset.

Taxpayer points out that "Realty" is a publicly traded REIT on the New York Stock Exchange and that "no single shareholder owns 10[percent] or more of the voting power/beneficial interest/shares.

The Department agrees that neither "Investor" or "Realty" meet Indiana's definition of a "captive" REIT and that the dividends paid deduction is permitted for Indiana's income tax calculation. Under I.R.C. § 857, the dividends paid deduction essentially eliminates federal/Indiana taxable income for the two REIT entities.

However, the Department cautions that Taxpayer is not required to withhold tax because the REITs are entitled to

the dividend paid deduction. IC § 6-3-4-12(a) plainly requires that "every partnership" withhold tax on distributions paid to its nonresident partners by filing a composite return. The decision set out in this Letter of Findings is limited to the narrow circumstances in which an ultimate taxpayer (the REITs) is effectively exempt and the Taxpayer has provided documentation establishing as much.

Nonetheless, the Department agrees that Taxpayer, pursuant to [45 IAC 3.1-1-107\(a\)\(2\)](#), correctly reported its Indiana source income because Taxpayer has unequivocally established that the manner in which it reported the tax was "a reasonable method designed to reflect the ultimate tax liability due Indiana because of the partnership's activities."

## FINDING

Taxpayer's protest is sustained.

## II. Composite Tax - Underpayment Penalty.

## DISCUSSION

Taxpayer objects to the imposition of the ten percent "underpayment penalty."

IC § 6-3-4-4.1(b) imposes on each taxpayer the responsibility to make and pay a "declaration of estimated tax for the taxable years" if the amount of that estimated is more than \$1,000.

Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to the lesser of:

- (1) twenty-five percent (25[percent]) of such corporation's estimated adjusted gross income tax liability for the taxable year; or
- (2) the annualized income installment calculated in the manner provided by Section 6655(e) of the Internal Revenue Code as applied to the corporation's liability for adjusted gross income tax. IC § 6-3-4-4.1(c).

IC § 6-3-4-4.1(d) imposes a penalty if a taxpayer fails to pay the correct amount of estimated tax.

The penalty prescribed by [IC 6-8.1-10-2.1\(b\)](#) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

- (1) the annualized income installment calculated under subsection (c); or
- (2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year. *Id.*

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty."

Departmental regulation [45 IAC 15-11-2\(b\)](#) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

Departmental regulation [45 IAC 15-11-2\(c\)](#) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including the underpayment penalty - is presumptively valid.

As discussed in Part I above, the Department agrees with Taxpayer's substantive argument and that Taxpayer did not underpay its 2019 Indiana corporate income tax. Taxpayer "exercised ordinary business care and prudence . . . ." and the penalty should be abated.

## **FINDING**

Taxpayer's protest is sustained.

## **SUMMARY**

The Department agreed that Taxpayer was not required to withhold tax on behalf of its non-resident partners and agreed that the "underpayment" penalty should be abated.

January 12, 2021

*Posted: 03/31/2021 by Legislative Services Agency*  
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